

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF INDIANA
SOUTH BEND DIVISION

IN THE MATTER OF)	
)	
JAMES AARON HUDGENS and)	CASE NO. 01-32667 HCD
PAMELA FAYE HUDGENS,)	CHAPTER 7
)	
DEBTORS.)	
)	
)	
NEW EQUIPMENT LEASING, INC.,)	
PLAINTIFF,)	
vs.)	PROC. NO. 01-3111
)	
JAMES AARON HUDGENS and)	
PAMELA FAYE HUDGENS,)	
DEFENDANTS.)	

Appearances:

Donald Visser, Esq., attorney for plaintiff, Grandville State Bank Building, Grandville, Michigan 49418;

Frank E. Schaffer, Esq., attorney for plaintiff, Zappia and Zappia Law Office, 52582 State Road 933 North, South Bend, Indiana 46637; and

Michael K. Banik, Esq., attorney for defendants, 217 South Fourth Street, Elkhart, Indiana 46516.

MEMORANDUM OF DECISION

At South Bend, Indiana, on January 14, 2003.

Before the court is the Complaint to Determine Dischargeability of Debts and Objecting to Discharge filed by the plaintiff New Equipment Leasing, Inc. (“plaintiff” or “NEL”) against the defendants James Aaron Hudgens and Pamela Faye Hudgens (“defendants” or “debtors”). The complaint was brought under 11 U.S.C. § 523(a)(2) and § 727(a)(4) and (a)(5). Following a trial on the issues, the court took the complaint under advisement. For the reasons that follow, the court denies the plaintiff’s complaint.

Jurisdiction

Pursuant to 28 U.S.C. § 157(a) and Northern District of Indiana Local Rule 200.1, the United States District Court for the Northern District of Indiana has referred this case to this court for hearing and determination. After reviewing the record, the court determines that the matter before it is a core proceeding within the meaning of § 157(b)(2)(I) and (J) over which the court has jurisdiction pursuant to 28 U.S.C. §§ 157(b)(1) and 1334. This entry shall serve as findings of fact and conclusions of law as required by Federal Rule of Civil Procedure 52, made applicable in this proceeding by Federal Rules of Bankruptcy Procedure 7052 and 9014. Any conclusion of law more properly classified as a factual finding shall be deemed a fact, and any finding of fact more properly classified as a legal conclusion shall be deemed a conclusion of law.

Background

A. Procedural History

The debtors filed their bankruptcy petition under chapter 7 of the Bankruptcy Code on May 25, 2001. NEL filed its complaint against the debtors on August 27, 2001. It alleged that the debtors provided NEL a materially false, intentionally deceptive financial statement in order to receive a lease. It further alleged that the debtors made a false oath or account and/or failed to explain satisfactorily any loss or deficiency of assets. It asked the court to find that the debt due on the defaulted obligation be excepted from discharge pursuant to § 523(a)(2) and that the debtors be denied a discharge pursuant to § 727(a)(4) and (a)(5). Because the debtors failed to plead or otherwise to defend in this case, the court entered a default against them on October 23, 2001. After the plaintiff filed its Motion to Enter Default on November 16, 2001, the court scheduled a hearing on the motion for January 10, 2002. However, on December 7, 2001, the debtors filed their Answer to Complaint. In it the debtors asserted that the information on the financial statement was correct when it was submitted, but that the properties held by the debtors were mortgaged or sold shortly thereafter. They explained that the debtor's

serious leg injuries caused him not to be able to work for three months. The Creditor's Motion to Strike, asking that the answer be stricken as untimely, was filed on December 19, 2001.

At the January 10, 2002, hearing, the court denied the plaintiff's motions to strike the answer and to enter a default judgment; it then set forth the discovery and pre-trial schedule. The court conducted its pre-trial conference on the plaintiff's complaint on June 19, 2002. Following the conference, the parties submitted their contentions for the upcoming trial. The trial scheduled for August 20, 2002, was continued, upon motion of the plaintiff's counsel, to October 7, 2002. The court conducted the trial on October 7 and 15, 2002. At the conclusion of the evidence, the court denied the defendants' motion for directed verdict and heard the parties' closing arguments. On October 18, 2002, the court took the complaint under advisement.

B. Factual Background and Contentions of the Parties

The debtor James Hudgens has been in the contracting and excavating business as a sole proprietor for twelve years. He wanted to lease a roller and a paver for his business. He signed a lease agreement with the plaintiff NEL on April 20, 2000. The agreement was based upon information provided by the debtors about their financial situation and assets. Pursuant to that agreement, the debtors leased the two pieces of equipment on a monthly term of \$730.79 for 60 months. However, when the debtors defaulted on the agreement, the items were repossessed and sold at auction. On February 19, 2001, the plaintiff obtained a judgment of \$38,326.38 in a Michigan court, based on the deficiency of the amount owed after the sale of the equipment. The Hudgenses filed a chapter 7 bankruptcy petition on May 25, 2001.

According to NEL, the assets listed on the debtors' bankruptcy schedules were different from those reported on the financial statement, entitled "Personal Statement," submitted to the plaintiff. NEL asserted that a comparison of that financial statement with the debtors' 1998, 1999, and 2000 tax returns and James Hudgens' deposition testimony reflected different incomes and asset levels, as well. The plaintiff concluded, after such a

comparison, that the Personal Statement submitted to the plaintiff was not accurate and was so different from the other filings as to be materially false and misleading. It asked the court to find that the debtors' debt to the plaintiff is nondischargeable and that their discharge is denied under § 727(a)(4) and (a)(5).

The debtors responded that they never provided materially false information to the plaintiff. According to the debtors, the plaintiff specifically advised them that it needed a financial statement only for its files and that the lease was approved based on the debtors' credit rating alone. The debtors insisted that the plaintiff thus did not rely on any information that was false or materially misleading.

C. Trial Evidence

At trial, it was the plaintiff's position that the debtors, in order to obtain a lease from the plaintiff, executed a materially false financial statement which overstated their income and assets. Alternatively, claimed the plaintiff, if the debtors' financial statement is correct, then their bankruptcy schedules are fraudulently incorrect. The debtors could not have moved from such a high income to such a low one, or from so many to so few assets, without a fraudulent transfer of assets, the plaintiff contended. The plaintiff also insisted that it reasonably relied on the intentionally deceptive financial statement to its detriment.

The debtors responded that the financial statement submitted to the plaintiff was accurate when they filled it out. It included properties that were listed in James Hudgens' name on which he would set a modular home. For that reason, their gross income with such properties was \$60,000 a month. Moreover, they asserted that the plaintiff told them that their credit report was fine. However, within weeks of entering into the equipment leases, the debtor injured his knee and could not work for months. By the time he filed bankruptcy, on May 25, 2001, he had sold his assets and returned the leased equipment to the creditors.

The first witness to testify at the trial was John Nienhuis, formerly the sales manager for New Equipment Leasing and, for eight years prior to that, a collection and loan officer with a financial institution. At

NEL he was authorized to approve the credit of a credit applicant like James Hudgens. He testified that Jim Spock worked directly with the Hudgenses when they applied for the loan and that he reviewed their credit file. He reviewed the debtors' personal financial statement and, relying on its information, approved their lease for approximately \$35,000 of equipment. *See* Pl's Ex. 1 ("Personal Statement"). According to the witness, James Hudgens put down about \$3,400 as a security deposit.

Mr. Nienhuis stated that he would not have approved the lease if he had known that the information was not correct. He identified the material information on the statement: the applicants' income, the number of years in business, the net equity, and the list of the real estate owned. He assumed that the debtors' listed salary, an average of \$40,000 per month, was gross income. He testified that he also assumed the accuracy of that monthly salary information; he did not ask for appraisals or supporting information and did not discuss the Hudgenses' application with Mr. Spock. Mr. Nienhuis stated that he did contact some trade and bank references and ran a credit report on James Hudgens. Both the references and the credit report were very good, he reported. He also acknowledged that Mr. Hudgens made some payments on the lease and that the plaintiff reclaimed the equipment to lease or to sell after the debtors' default on their payments.

The debtor, James Hudgens, next was called as an adverse party witness. He acknowledged that he and his wife prepared the Personal Statement and submitted it by fax to the plaintiff on April 13, 2000. He wanted to lease two pieces of equipment, a roller and a paver. Referring to the debtors' Personal Statement, the plaintiff questioned items listed on it. The plaintiff first asked whether the debtor ever had drawn a salary of \$40,000 a month, as he claimed on the Personal Statement. The debtor explained that, because he never actually drew a salary, he calculated his monthly salary by dividing his yearly gross income by 12. When asked how he calculated his average monthly real estate income at \$20,000, he explained that his business was selling homes and that he had sold approximately 30 homes since 1997. According to the debtor, he probably sold seven homes each year, on the average, and his income from the sale of each home was about \$35,000. By his calculations,

therefore, he earned about \$240,000 a year or \$20,000 a month. The debtor explained that he turned in all the sales information to his accountant to report on his tax returns.¹ However, he made clear that the plaintiff's representative told him that only the credit report, and not the Personal Statement, counted in its determination to grant the lease. With respect to his personal residence, the debtor was asked to explain the difference between the values listed on his April 2000 Personal Statement (listing the market value of his home at \$119,000 and the mortgage balance at \$80,000) and his bankruptcy schedules in May 2001 (listing the market value at \$110,000 and the mortgage balance at \$99,000). He stated that he got a second mortgage for \$20,000 to pay off his dump truck and to cover other bills.

On the Personal Statement, the debtor listed the value of his vehicles at \$187,000. However, on the bankruptcy schedule the vehicles were listed at \$40,000. The debtor explained that, in order to pay bills, he sold most of his vehicles — his motor cycle, car, boat, bobcat, trailers and dump truck — in the summer of 2000. At the time of his bankruptcy, he owned only a pickup truck worth \$10,000 and a Trans Am worth \$35,000, and he owed almost \$10,000 on the pickup and \$32,000 - \$35,000 on the car. He used the money from the sale of the vehicles to pay off the vehicles and other debts. For some of the equipment, however, he received only the amount owed. For example, he sold the bobcat for \$13,000, which was the amount he still owed on it. In the case of the dump truck, its value was \$40,000 but he was able to sell it for only \$13,000. The plaintiff accused the debtor of not reporting all the transactions on his 2000 tax return.

The debtor admitted that the government bonds he listed on schedule B of the Personal Statement were erroneously listed at their market value of \$15,000. He stated that there were two bonds worth about \$5,000. He also admitted that he had a life insurance policy worth \$100,000, and not \$1,000,000, as his Personal

¹ The debtors' tax returns for the years 1998, 1999, and 2000 were admitted in evidence with the stipulation that the plaintiff did not rely on those documents in determining whether to approve the debtors' lease. The documents demonstrated that, in 1997, the debtors' total income was \$25,007; in 1998, their income was a negative amount of \$29,702; in 1999, they had a negative income of \$11,806; and in 2000, they reported a negative income of \$60,420. The deposition of James Hudgens was not entered in evidence.

Statement reported. However, he explained that he and his wife did not spend hours on this Personal Statement form and believed that the amounts on it were allowed to be approximate, because they were told that the loan was based on his favorable credit report and not on the Personal Statement. The debtor testified that he filled out the form to the best of his ability and that, if the plaintiff had wanted a complete financial statement, it should have asked for his tax returns. He further stated that he offered to give the plaintiff his tax returns, but was told that it would give him the loan without those returns. According to the debtor, the plaintiff's representative told him that the Personal Statement was irrelevant, that he already was approved, and that the important information was found on his credit report.

On cross examination, the debtor explained that he has been a contractor for twelve years and has excavated — putting in septic tanks, sewers, crawl spaces, and asphalt driveways — for six years as a sole proprietor. When Hart Homes of Wakarusa sold a modular home, he stated, he put it on the person's property by excavating the site, setting the house, pouring the driveway, and landscaping. With respect to Schedule C of the Personal Statement he sent to the plaintiff, he pointed out that the Koontz Lake listing on Schedule C was a property that had not sold. He explained, however, that the "present market value" of the listed property was the amount listed by a realtor and that the "cost" of the home was the amount he spent on building the house. His father would lend him the money he needed, and he would pay his father back when the house sold, with 10% interest. Because there was no mortgage on the property, he said, he listed a "0" balance and "0" monthly payments for the mortgage. Whenever a house would sell, the realtor would keep the cost of the land and he would receive the remaining proceeds. He said that he normally paid his father and his suppliers with those proceeds.

The debtor reviewed the assets he listed on the Personal Statement. He testified that he included boats, motorcycles, and cars under the category of "Automobiles." He explained that he sold those items to pay what was owed on them and to pay for other equipment as well.

The debtor saw the roller and paver in an equipment magazine. According to the debtor, the seller suggested that he finance the equipment through NEL, and NEL then contacted him. The roller and paver together cost \$40,000. Although they were not new, the quality of the equipment was good, and the debtor felt they were a good buy. He received the roller and paver two weeks after he got the loan. The debtor had gotten two loans in the past, as well, and was told that his credit was high. At the time he filled out the credit application for the plaintiff, he understood that he already was approved.

A week or two after he received the equipment, James Hudgens injured his knee and could not work for eight weeks. As a result, he could not generate any cash flow. He was obligated to pay employees he had hired for the asphaltting and to pay the equipment leases, even though he could not work. Hounded by creditors, he said, he decided to downsize by selling all the equipment he did not need and by keeping only one employee. He stopped his asphaltting business. He returned the roller and paver, which he had used only eight times, to the plaintiff. He explained that the condition of the equipment was far better than when he had received it, because his employees had cleaned and fixed up the equipment while he was injured. In addition, he had made a down payment of about \$3,500 and six payments on the equipment. After his checks started bouncing and after a lawsuit ended with a judgment against him, he contacted an attorney about filing bankruptcy. He testified that his bankruptcy schedules are true and correct.

On redirect examination, however, the debtor conceded that he did not actually own the real estate listed on Schedule C of the Personal Statement. The plaintiff wanted to determine what happened, in the thirteen-month period between the filling out of the Personal Statement and the bankruptcy schedules, to the \$450,000 of claimed net worth. The plaintiff asked where on the Personal Statement the debtor had listed his debt of \$32,000 to GMAC for the purchase of the Firebird. The debtor said he thought he had incorporated that debt under "Total Liabilities," since there was no separate category for automobile liabilities. He stated that he reported "0" contingent liabilities because he was not sure what "contingent" meant and because he did not think he had such

liabilities: There were no legal claims against him, no tax debt, no leases or contracts, and he was not, as far as he knew, an endorser or guarantor. When the plaintiff pointed out that Hudgens owed his father and suppliers and had a land contract, the debtor acknowledged those debts but did not recognize that they were “contingent liabilities.” He admitted that he did not disclose those losses on his financial statement.

On his bankruptcy Statement of Financial Affairs, the debtor stated that he earned no “income received other than from employment” for the two years prior to bankruptcy. However, the plaintiff pointed out that, on the Personal Statement filed with the plaintiff within that two-year period, he reported receiving land contract income. The debtor explained that he received \$775 for a land contract but then had to make payments on the land contract from that amount, and so in the end he did not earn anything on that contract. The plaintiff asked whether the debtor had income from sources other than employment. The debtor insisted that he had no income other than from his employment or his business.

The debtor was asked about the \$20,000 of real estate income listed on the Personal Statement but not on the bankruptcy schedules. He explained that selling real estate was part of his job and that the payment was therefore employment income. Because it was not income from sources other than employment, he did not include it separately on his bankruptcy schedules. He also stated that he had made oral contracts with his father and with others, and that he paid people back whenever he could. He was not sure, however, whether the payments were made within ninety days of the bankruptcy.

The plaintiff asked why the debtor did not report on his schedules that tools worth \$2,500 were stolen from a job site. The debtor explained that the loss occurred in January 2002, after the bankruptcy was filed. He also testified that he had \$25,000 in First Source Bank when he filled out the Personal Statement, but that he used the \$25,000 to pay bills after he injured his knee. He explained that he sold his boat in June or July of 2001 and paid bills and employees with the proceeds. With respect to his credit card obligations totaling about \$86,000, the debtor stated that he paid bills and bought building materials with credit cards but bought nothing for himself. He

may have used the credit cards for gas or for Christmas gifts for his children, but not anything personal for himself. None of the credit card debt was incurred within 90 days of filing bankruptcy, he testified. The J.C. Penny card is his wife's, he added.

The debtor said that he understood that the property he "owned" was property on which he did not have a loan. If there is a loan on it, he continued, the bank really owns the property. He explained further that he owns, not rents, his home, but because he has a mortgage on it he will not actually own it until he has paid off the mortgage. When he filled out the category "Real Estate Owned" on Schedule C of the Personal Statement, the debtor explained, he distinguished between owning the property or land and owning the home being built on the property. He actually owned the homes being placed on Koontz Lake and Bass Lake property, he insisted.

Nicholas E. Lanning, Chairman of the Board, chief stockholder, and one of the main operating officers of NEL, was the final witness. He testified that the Personal Statement gives a picture of the borrower's ability to make the financial obligation and the credit report gives the individual's payment history. With both, he explained, he sees the character and the capacity of the individual to make the lease payments. He testified that he would not make a lease without a financial statement.

The witness acknowledged that, in this case, the credit report was ordered and the financial statement was executed on one day and the lease was approved the next day. He conceded that he did not see the debtors' Personal Statement until after the lease was approved. He simply reviewed the file after the lease was approved to ensure that the file was complete. He testified that he did not rely on the Personal Statement and that he had no direct knowledge about what information was relied upon when NEL extended credit to the debtors.

At the conclusion of the parties' presentation of evidence, the debtors moved for a directed verdict. The court denied the motion, heard final arguments, and took the complaint under advisement.

Discussion

The issues raised in the plaintiff's complaint are whether the debtors' debt to the plaintiff is excepted from discharge under 11 U.S.C. § 523(a)(2) and whether the debtors should be denied a discharge under 11 U.S.C. § 727(a)(4) or (a)(5). The court will consider each allegation of the complaint in turn.

A. 11 U.S.C. § 523(a)(2)

The plaintiff alleged that it was induced to enter into a lease agreement with the debtors by the debtors' materially false and deceptive financial statement on which the plaintiff relied to its detriment. The issue before the court, therefore, is whether the debtors' debt to the plaintiff should be excepted from the debtors' discharge pursuant to § 523(a)(2)(B), which provides that a debtor is not discharged from a debt —

for money [or] property . . . to the extent obtained by — . . . (B) use of a statement in writing —

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive.

11 U.S.C. § 523(a)(2)(B).

A debt may be found nondischargeable under § 523(a)(2)(B) when there is an actual writing respecting the debtor's financial condition and when it satisfies the four elements of subsection (B). *See In re McFarland*, 84 F.3d 943, 946-47 (7th Cir.), *cert. denied*, 519 U.S. 931 (1996) (analyzing the statutory language); *In re Sheridan*, 57 F.3d 627, 633-34 (7th Cir. 1995) (considering element of intent). The creditor NEL has the burden of proving by a preponderance of the evidence that the debt meets all of these requirements. *See Grogan*

v. Garner, 498 U.S. 279, 291, 111 S.Ct. 654, 661, 112 L.Ed.2d 755 (1991); *In re McFarland*, 84 F.3d at 946.

The court finds that the Personal Statement was a statement in writing concerning the financial condition of these debtors. At issue is whether the plaintiff was successful in demonstrating that it relied on that statement in granting the loan to the debtors, that its reliance was reasonable, and that the Personal Statement was materially false or intentionally deceptive.

The court begins by considering whether the plaintiff has demonstrated reasonable reliance. The determination of whether a creditor reasonably relied on a false statement is a question of fact to be determined on a case-by-case basis. *See In re Bonnett*, 895 F.2d 1155, 1157 (7th Cir. 1989). When determining reasonable reliance, “[t]he bankruptcy court may consider, among other things: whether there had been previous business dealings with the debtor that gave rise to a relationship of trust; whether there were any “red flags” that would have alerted an ordinarily prudent lender to the possibility that the representations relied upon were not accurate; and whether even minimal investigation would have revealed the inaccuracy of the debtor’s representations.” *In re Morris*, 223 F.3d 548, 554 (7th Cir. 2000) (quoting *Coston v. Bank of Malvern (In re Coston) (per curiam)*, 991 F.2d 257, 261 (5th Cir. 1993)). The reliance is not reasonable “if the investor knows or suspects the truth” or “possesses information sufficient to call the representation into question.” *Mayer v. Spanel Int’l, Ltd.*, 51 F.3d 670, 676 (7th Cir.), *cert. denied*, 516 U.S. 1008 (1995). For example, when a creditor had serious doubts about the veracity of a debtor’s financial statement but did not attempt to ascertain the debtor’s true financial condition, the creditor’s reliance on that financial information was found to be unreasonable. *See In re Morris*, 223 F.3d at 554 (finding that the bankruptcy court did not clearly err in finding that the creditor’s reliance was not reasonable). However, “where there are no red flags to suggest that a debtor has made a false statement, the creditor has no duty to investigate the truth of the debtor’s statements.” *Huntington Nat’l Bank v. Perk (In re Perk)*, 227 B.R. 846, 849 (Bankr. S.D. Ind. 1998) (following *Mayer v. Spanel*). A court

evaluating a financial statement, therefore, examines the totality of the circumstances to find whether the plaintiff's reliance on the statement was reasonable.

In this case, the plaintiff specifically asserted that the debtors fraudulently misrepresented their financial condition on the Personal Statement that was part of their loan application. Challenging the truthfulness of the debtors, the plaintiff contended that the debtors' claimed income of \$700,000 was not reflected on their tax returns, their bankruptcy schedules, or in James Hudgens' deposition. It claimed that the financial statement, by overstating the debtors' income and assets and by failing to list negative information, suggested that they were capable of paying back the loan. NEL asserted that it relied on the debtors' financial statement and extended credit as a result, to its detriment.

The debtor James Hudgens testified in detail about the circumstances that led to his credit application and to the plaintiff's approval of his lease. According to the debtor, the plaintiff initiated its business relationship with the debtors by contacting him about financing the paver and roller. The plaintiff's representative told Hudgens that he already was approved to lease the equipment, based on the credit report it received about him. Once the plaintiff had the credit report, the debtor stated, the representative sent the debtors the Personal Statement to fill out and to return to NEL by fax. The debtor testified that he told the NEL representative that their tax returns did not look good and even offered to submit the tax returns to NEL. However, the representative told him that he already was approved and that NEL did not need the tax returns. Therefore, claimed the debtor, the plaintiff did not rely on the tax returns or on the Personal Statement.

The court notes first that the testimony of all three witnesses at the trial was credible. The debtor's testimony that he was told that his lease application was approved, based on the credit report rather than the Personal Statement, was presented straightforwardly, as a clear and believable rendition of the factual history, and was unrebutted. Jim Spock, who was named as the plaintiff's representative who apparently worked directly with the debtors and gave such an assurance, did not testify. Mr. Nienhuis testified that he approved the

Hudgenses' application after receiving the credit report and the Personal Statement. He said that he assumed the accuracy of the debtors' financial information and did not check it with Jim Spock. He did not question the listed monthly salary of \$40,000 or monthly real estate income of \$20,000. The court determines that Mr. Nienhuis, impressed by the debtors' good references and credit report, did not place much, if any, weight on the financial statement they submitted. His testimony did not contradict James Hudgens' statement that the NEL representative had assured Hudgens that he had been approved for a lease before the submission of his Personal Statement because of his good credit report. Nor did Mr. Lanning's testimony rebut that statement, for he stated candidly that he did not know what information was relied upon when NEL extended credit to the debtors. The court finds, therefore, that the testimony of the debtor, the only person to testify about the transaction concerning the Personal Statement and about the reasoning used in filling out the financial data, was unrefuted and credible.

Based on that testimony, the court further finds that NEL either did not rely at all or did not rely reasonably on the Personal Statement filled out by the debtors. The court recognizes that "the concept of reasonable reliance does not generally require creditors to conduct an investigation prior to entering into agreements with prospective debtors." *In re Morris*, 223 F.3d at 554. Nevertheless, creditors should take such a precaution as "the ordinarily prudent choice" when "'red flags' . . . would have alerted an ordinarily prudent lender to the possibility that the representations relied upon were not accurate." *Id.*; see also *In south Bank v. Michael (In re Michael)*, 265 B.R. 593, 600 (Bankr. W.D. Tenn. 2001) (stating that, even though a lender does not have an independent duty to verify the absolute accuracy of a financial statement, it cannot ignore red flags, inaccuracies and inconsistencies and later assert reasonable reliance).

In this case, the creditor, at trial, raised numerous "red flags" from the Personal Statement that perhaps should have been investigated before extending credit to the debtors: the debtors' reported monthly salary of \$40,000, monthly real estate income of \$20,000, and ownership of \$388,700 in real estate and \$187,000 in automobiles. Mr. Neinhuis testified that the information on the financial statement that he considered material

included the debtors' income and the list of the real estate owned. However, he further testified that he assumed the accuracy of the listed monthly income of \$40,000 and monthly real estate income of \$20,000. Although he said he would not have approved the lease if he had known that the information was incorrect, he did not discuss the application with Jim Spock or question the accuracy of the debtors' financial data. He clearly relied on the references and the credit report which, he testified, were very good. In the view of this court, it would be reasonable for a credit officer to ask questions of an applicant, especially one with whom it had no previous business relationship, professing to have assets of \$710,000, an annual income of \$700,000 and liabilities of \$260,000. The court finds that neither the NEL representative who dealt directly with the Hudgenses nor Mr. Nienhuis, who approved their application, reviewed crucial information on the Personal Statement in a critical way. *See In re Smith*, 278 B.R. 532, 539 (Bankr. N.D. Okla. 2002) (noting that a loan officer overlooked or chose to ignore red flags); *see also Guess v. Keim (In re Keim)*, 236 B.R. 400, 402 (8th Cir. B.A.P. 1999) (upholding bankruptcy court's determination that a creditor's blind reliance on a purchaser's financial statement was not reasonable). In the eyes of the court, the information on the Personal Statement reasonably would have brought into question the accuracy of the data and would have induced the plaintiff to investigate the debtors' situation before extending credit. *See First National Bank v. Pontow*, 111 F.3d 604, 610 (8th Cir. 1997) (finding that the record contained evidence of red flags and that the lender did not reasonably rely on the financial information).

In conclusion, the court determines that, if the plaintiff placed any weight on the financial statement submitted by the debtors, it did not reasonably rely on it when approving the lease. *See In re Morris*, 223 F.3d at 553 (acknowledging that "a creditor should not be denied protection against discharge unless the 'creditor's claimed "reliance" on a "financial statement" would be so unreasonable as not to be actual reliance at all") (quoting *Northern Trust Co. v. Garman (In re Garman)*, 643 F.2d 1252, 1256 (7th Cir. 1980), *cert. denied*, 450

U.S. 910 (1981)).² Instead, it minimally reviewed and approved the debtors' application and credit report in one day. Because the plaintiff did not prove that it reasonably relied on the written financial statement supplied by the debtors, the court finds that the debtors' debt to the plaintiff is not excepted from the debtors' discharge pursuant to 11 U.S.C. § 523(a)(2)(B).

Although the court need not consider any of the other elements under § 523(a)(2)(B), it also finds, after examining the totality of the circumstances, that the plaintiff failed to show that the debtors' Personal Statement was made with intent to deceive. In order to prevail on a claim under 11 U.S.C. § 523(a)(2)(B)(iv), a creditor must prove by a preponderance of the evidence that a debtor made a materially false written financial statement with an intent to deceive. *See In re Sheridan*, 57 F.3d 627, 633 (7th Cir. 1995). The intent may be proven through direct or circumstantial evidence. *Id.* (stating that "wrongful intent may 'logically be inferred from a false representation which the debtor knows or should know will induce another to make a loan'") (quoting *In re Kimzey*, 761 F.2d 421, 424 (7th Cir. 1985)).

At trial, James Hudgens gave reasonable explanations for the financial data he submitted on the Personal Statement. The court finds that the debtors' report of their business and personal finances reflected that they were unsophisticated in financial matters. For example, they listed under Assets that they owned \$388,700 in real estate, but stated parenthetically in Schedule C that it was "investment property for sale." *See AT&T Universal Card Servs. v. Mercer (In re Mercer)*, 246 F.3d 391, 410 (5th Cir. 2001) (stating that, if a debtor does not know the representation is false, there is no misrepresentation and no intent to deceive). The court also finds that the debtors, believing they already were approved for the lease, filled out the Personal Statement sloppily or

² Although the court recognizes that it must not "second-guess a creditor's lending decisions," *In re Morris*, 223 F.3d at 553, it questions whether such a brief evaluation of the credit-worthiness of these debtors, with whom the plaintiff had no prior business dealings, was a normal business practice for this creditor. *See In re Smith*, 278 B.R. at 539; *see also Lease Corp. of America, LCA v. Harloff (In re Harloff)*, 272 B.R. 496, 500 (Bankr. M.D. Fla. 2001) (finding that there is more reason to investigate a lease application when the creditor and debtor did not have an existing relationship).

carelessly but not deceptively or with a reckless disregard for the truth. *See In re Sheridan*, 57 F.3d at 634. Had an NEL representative discussed the Personal Statement with the debtors, he might have categorized the assets and liabilities differently and might have found that some of the data was inflated or even materially false. However, no NEL representative investigated the information on the Personal Statement. In the view of the court, the evidence at trial did not demonstrate that the debtors made representations to NEL that they knew or had to know were false. *See Cutillo v. Hubner (In re Cutillo)*, 247 B.R. 766, 771 (S.D. Ind. 2000) (affirming bankruptcy court's finding that the debtor intended to deceive the creditors because he had to know that his financial information was false). Moreover, the debtor gave plausible explanations of the differences between his Personal Statement and his bankruptcy schedules. The plaintiff did not present evidence that contradicted the debtor's account of his injury, his inability to work, his mounting bills, his selling of most of his equipment and laying off of employees, and his filing of a chapter 7 petition. The court finds that the plaintiff failed to meet its burden of proving that the Hudgenses submitted the financial statement to it with intent to deceive.

Based on its findings that the plaintiff did not demonstrate by a preponderance of the evidence (1) that it reasonably relied on the debtors' Personal Statement and (2) that the debtors tendered that written financial statement with an intent to deceive, the court denies the complaint with respect to § 523(a)(2)(B).

B. 11 U.S.C. § 727

The remaining issue before the court is whether the debtors' discharge should be denied under 11 U.S.C. § 727(a)(4) or (a)(5). A court should construe the exceptions to discharge "strictly against the creditor and liberally in favor of the debtor." *In re Juzwiak*, 89 F.3d 424, 427 (7th Cir. 1996) (citations omitted). When reviewing § 727(a) claims, however, a court should consider "that a discharge in bankruptcy is a privilege, not a right, and should inure to the benefit of the honest debtor." *Id.* (citations omitted). Section 727 authorizes a denial of discharge if the debtor is shown to have engaged in improper conduct as described in one or more of its

subsections. The creditor must establish grounds for denial of discharge under 11 U.S.C. § 727(a) by a preponderance of the evidence. *Peterson v. Scott (In re Scott)*, 172 F.3d 959, 966-67 (7th Cir. 1999). If the creditor is successful, the burden shifts to the debtor to prove by competent evidence that he did not commit the offense charged. “The general rule is that the right to a discharge is left to the sound discretion of the bankruptcy court.” *Prairie Prod. Credit Ass’n v. Suttles (In re Suttles)*, 819 F.2d 764, 766 (7th Cir. 1987).

(1) 11 U.S.C. § 727(a)(4)

The Bankruptcy Code requires the court to grant the debtor a discharge unless, under § 727(a)(4), the debtor knowingly and fraudulently, in or in connection with the case —

(A) made a false oath or account;

(B) presented or used a false claim;

(C) gave, offered, received, or attempted to obtain money, property, or advantage, or a promise of money, property or advantage, for acting or forbearing to act; or

(D) withheld from an officer of the estate entitled to possession under this title, any recorded information, including books, documents, records, and papers, relating to the debtor’s property or financial affairs.

11 U.S.C. § 727(a)(4). “A debtor’s knowing and fraudulent false oath is cause to deny a discharge.” *In re Hall*, 258 B.R. 908, 913 (Bankr. N.D. Ind. 2001).

Not every false oath is sufficient to do so however. The false oath must also be material. To be material the testimony must relate to such things as the debtor’s estate, assets, liabilities and financial affairs, the disposition of property, or debtor’s entitlement to discharge.

Id. (citing *In re Senese*, 245 B.R. 565, 574 (Bankr. N.D. Ill. 2000)). The plaintiff has the burden of proving that the debtor’s oath or account was false; then the burden shifts to the debtor to justify his actions. *See Hillis v. Martin (In re Martin)*, 124 B.R. 542, 545 (Bankr. N.D. Ind. 1991). Specifically, the plaintiff is required to establish that (1) the debtor made a statement under oath, (2) the statement was false, (3) the debtor knew the statement was false, (4) the debtor made the statement with fraudulent intent, and (5) the statement related

materially to the bankruptcy case. See *Krudy v Scott (In re Scott)*, 227 B.R. 834, 841 (Bankr. S.D. Ind. 1998); *In re Kressner*, 206 B.R. 303, 316 (Bankr. S.D.N.Y. 1997).

The plaintiff stated that the debtors signed both the Personal Statement and their bankruptcy schedules “under oath,” thirteen months apart, and yet there was a difference of about \$450,000 of net worth between those two documents. NEL insisted that they intended to deceive NEL by inflating the values of their assets in order to obtain the lease. They also claimed that, if the figures in the Personal Statement are correct, then the debtors must have disposed of \$450,000 in assets by the time they filed their bankruptcy. The debtors responded that both forms, the financial statement to NEL and the bankruptcy schedules, were filled out truthfully and accurately, to the best of their ability. James Hudgens stated that his leg injury, which occurred after he obtained the NEL lease, led to his financial downfall and bankruptcy filing. He sold his business equipment and returned leased property once his bills mounted, but had to file bankruptcy when his creditors became insistent, he stated. He explained at trial the reasons for giving the figures in each document and insisted that he truthfully report their financial circumstances with no intent of deception.

The court finds that the debtors’ schedules constitute a statement under oath, and their Personal Statement will be treated as a statement under oath for purposes of a discharge objection under § 727(a)(4).³ See *Stathopoulos v. Bostrom (In re Bostrom)*, 286 B.R. 352, 360 (Bankr. N.D. Ill. 2002). However, the court also finds that the objecting creditor NEL did not demonstrate by a preponderance of the evidence that the oaths were made knowingly and fraudulently. The plaintiff argued that, with a loss of \$450,000 of assets between the filing of the two documents, at least one of those statements under oath must be false. However, at trial James Hudgens presented a credible, more complete picture of the circumstances that led to their loss of assets. He was able to explain and to reconcile the differences between the financial data presented on the Personal

³ The Personal Statement includes the following statement above the signature lines of the applicants: “We fully understand that it is a federal crime punishable by fine or imprisonment or both to knowingly make any false statements” concerning the information given in the Statement.

Statement submitted to NEL and the schedules filed in their bankruptcy proceedings. In the end, the creditor did not show specific information — nondisclosures or mistaken values of assets, for example — on the financial statement or bankruptcy schedules that the debtor did not explain.

The court finds that the plaintiff failed to show that the debtors made either of the documents with fraudulent intent. The court found in the previous section of this Memorandum of Decision that the plaintiff did not prove the debtors' intent to deceive in the Personal Statement, and the court further finds that the schedules do not reflect such an intent. Those documents might reflect poorly kept records, careless reporting, or inadvertent mistake but they are not evidence of fraud. *See Gullickson v. Brown (In re Brown)*, 108 F.3d 1290, 1294 (10th Cir. 1997). The plaintiff did not demonstrate which of the documents had incorrect information or which entries were made with the knowledge that they were false and deceptive. The court will not infer fraudulent intent in such a circumstance. *See id.* at 1294-95 (“A debtor will not be denied discharge if a false statement is due to mere mistake or inadvertence. Moreover, an honest error or mere inaccuracy is not a proper basis for denial of discharge.”); *see also Casa Investments Co. v. Brenes (In re Brenes)*, 261 B.R. 322, 337 (Bankr. D. Conn. 2001) (refusing to deny a discharge when “the untruth has been a result of mistake or inadvertence”). Because the plaintiff did not satisfy the essential elements of § 727(a)(4) by a preponderance of the evidence, the court concludes that the debtors' discharge is not denied on this ground.

(2) 11 U.S.C. § 727(a)(5)

The Bankruptcy Code provides that a debtor may be denied a discharge in bankruptcy if “the debtor has failed to explain satisfactorily . . . any loss of assets or deficiency of assets to meet the debtor's liabilities.” 11 U.S.C. § 727(a)(5). This statute gives the bankruptcy court “broad power to decline to grant a discharge . . . where the debtor does not adequately explain a shortage, loss, or disappearance of assets.” *In re D'Agnese*, 86 F.3d 732, 734 (7th Cir. 1996) (quoting *In re Martin*, 698 F.2d 883, 886 (7th Cir. 1983)).

In a § 727(a)(5) challenge, as in all § 727(a) claims, the initial burden is on the party objecting to a discharge; once that party's evidence is presented, the burden shifts to the debtor to explain the loss or deficiency of assets. The statute "requires a *satisfactory* explanation for the whereabouts of a debtor's assets." *In re D'Agnese*, 86 F.3d at 734. The question of whether a debtor has satisfactorily explained a loss of assets is a question of fact. The debtor's explanation must be more than vague, indefinite and uncorroborated assertions. *See id.* It must be reasonable and credible enough to satisfy the court that the creditors need not speculate about where the assets went. The failure to offer documentary evidence to corroborate a debtor's testimony as to the loss or disposition of assets may justify the denial of a discharge pursuant to § 727(a)(5). *See In re Farouki*, 133 B.R. 769, 777 (Bankr. E.D. Va. 1991) (citing *In re Chalik*, 748 F.2d 616, 619 (11th Cir. 1984)). Nevertheless, this circuit has made it clear that "a debtor may violate § 727(a)(5), which has no fraudulent intent requirement, and still receive a discharge." *In re Suttles*, 819 F.2d at 766 n.2.

The plaintiff claimed that the debtors were not candid to the court with respect to the undisclosed transactions with James Hudgens' father and the disappearance of substantial assets within ninety days or within one year of the bankruptcy. It alleged that the debtors went through \$450,000 of net worth between the time they submitted the Personal Statement and the time they filed bankruptcy. They neither explained the loss nor brought their records to prove the accuracy of their financial statement. The plaintiff accused the debtors of using gross income when it was to their benefit and net income at other times. It claimed, as well, that the debtors inflated values to obtain the lease from the plaintiff and deflated the values when they filed their bankruptcy statements. According to NEL, the debtors' Personal Statement was false and was made with the intent to deceive NEL so that they could obtain an extension of credit.

The debtor James Hudgens responded that both the Personal Statement and the bankruptcy schedules were true and accurate and were filled out to the best of his ability. He explained that he is a contractor, not someone sophisticated in financial transactions, and that he based his information on what he knew. He also

asserted that NEL approved his application for a lease based on his credit report, before he submitted his Personal Statement. Several weeks after he obtained the NEL lease, he was injured and could not work. He could not pay his employees or his bills. He sold his equipment but eventually had to file bankruptcy. The debtors' bankruptcy schedules reflect their assets and liabilities after they sold assets and returned the equipment he had used in his business.

The court finds that the creditor has alleged a loss of \$450,000 of assets between the filing of the two documents, but never identified specific assets that were missing. *See Spiezio v. Vitek (In re Vitek)*, 271 B.R. 551, 558 (Bankr. S.D. Ohio 2001) ("It is not enough to merely allege a loss — there must be specifics."). Nevertheless, the court treated the plaintiff as having satisfied the initial burden of production and allowed the burden to shift to the debtor to explain those losses in a satisfactory way. It finds that the debtors gave an adequate and credible explanation of the method they used for listing assets and liabilities on the Personal Statement, the disposition of substantial assets after the lease was granted and James Hudgens was injured, and the subsequent listing of the remaining assets and liabilities on their bankruptcy schedules. Although the court would have preferred documentary evidence to support their sales or transfers of business equipment and other property, the court finds their explanations to be detailed and definite enough to be satisfactory. Despite the court's allowance of an opportunity for NEL to respond, the plaintiff failed to identify specific deficiencies and errors in the schedules and Personal Statement to contradict the debtors' explanations. *See In re Vitek*, 271 B.R. at 559 ("This is a case of innocent, incomplete and inaccurate disclosure of financial information, rather than an instance of concealment of assets or destruction of financial records.").

The court determines, therefore, that the debtor will not be denied a discharge under § 727(a)(5).

Conclusion

For the reasons stated above, the court grants judgment in favor of the debtors under counts I and II of the plaintiff's complaint. It finds that NEL's claim against the debtors, brought under 11 U.S.C. § 523(a)(2), is dischargeable in their bankruptcy case. It also denies the plaintiff's request that the debtors be denied a discharge pursuant to 11 U.S.C. § 727(a)(4) or (a)(5). In denying the plaintiff's complaint, the court finds the debtors' debt to NEL dischargeable and concludes that the debtors' discharge is not denied under § 727(a)(4) or (a)(5).

SO ORDERED.

Harry C. Dees, Jr., Chief Judge
United States Bankruptcy Court